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Date: April 15, 2003

To: County and District Superintendents  
County and District Chief Business Officials  
Charter School Administrators

From: Janet Sterling, Director  
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Subject: Fiscal Issues Resulting from Budget Cuts and Appropriation Deferrals

As you know, due to unprecedented declines in State revenues, in each of the last two years the Legislature and the Governor have enacted program reductions and tax increases, as well as a mix of fund shifts, loans, accelerations, transfers and deferrals, to help balance the State's budget. The latest of these actions is contained in Senate Bill 18 of the 2003-04 First Extraordinary Session (Chapter 4, Statutes of 2003). A summary of the recently enacted SBX1 18 can be found on our Web site at: <<http://www.cde.ca.gov/fiscal/budgetact>>.

In this letter, we will clarify some of the consequences of the Legislature's actions on your 2002-03 and 2003-04 budgets, and provide you with some guidance on how to budget, account for, and report these transactions.

### **Cash Flow Issues**

The state's current year budget cuts and appropriation deferrals may result in cash flow management problems for local educational agencies (LEAs) in the current year. To alleviate cash shortfalls, you may wish to consider the following options:

#### Interfund Borrowings

*Education Code* Section 42603 provides that moneys held in any fund or account may be temporarily transferred to another fund or account for payment of obligations, with certain limitations.

- Amounts transferred shall be repaid either in the same fiscal year, or in the following fiscal year if the transfer takes place within the final 120 calendar days of a fiscal year.
- Borrowing shall occur only when the fund receiving the money will earn sufficient income during the current fiscal year to repay the amount transferred.
- No more than 75 percent of the maximum of moneys held in any fund during a current fiscal year may be transferred.

Section 42603 also provides that the transfer shall be accounted for as temporary borrowing between funds or accounts and shall not be available for appropriation or be considered income to the borrowing fund or account. The accounting is a debit to Object Code 9310 *Due From Other Funds* and a credit to *Cash* in the lending fund, and a debit to *Cash* and a credit to Object Code 9610 *Due To Other Funds* in the borrowing fund. These amounts will be carried on the balance sheet until the entry is reversed when the funds are repaid. Note that temporary borrowings are not accounted for as interfund transfers, and do not affect the fund balance for either the borrowing or lending fund.

If you are considering borrowing from restricted programs and are concerned about the legality of doing so, we suggest you discuss the issue with your legal counsel. Also note that borrowings from certain restricted funds should be repaid with interest, if there are interest requirements relating to those programs or funds.

#### Short-term Borrowings from External Sources

**Tax Revenue Anticipation Notes.** Tax Revenue Anticipation Notes (TRANs) are short-term, interest bearing notes issued by a government in anticipation of tax revenues that will be received at a later date. The notes are retired from the tax revenues to which they are related. Many LEAs issue TRANs for cash flow management purposes every year. Note, however, that funds borrowed from TRANs are typically available only within the fiscal year, rather than across fiscal years.

**County Office of Education.** *Education Code* sections 42621 and 42622 authorize county offices of education to loan funds to school districts. The funds must be repaid either within the fiscal year or within the next fiscal year, depending on the type of loan that is granted. Certain other restrictions apply, as indicated in the applicable statutes. Note that such loans are discretionary and are subject to availability of funds at the county office level.

**County Treasurer.** *Education Code* Section 42620 requires the county board of supervisors to loan money to school districts when certain conditions exist. However, Section 6 of Article XVI of the Constitution of the State of California requires that such loans must be made before the

last Monday in April. Loan and repayment terms vary by county, so you may wish to coordinate with your county office of education.

**California School Finance Authority.** The California School Finance Authority (CSFA), which is under the umbrella of the State Treasurer, is currently working on urgency legislation that would enable them to provide short-term loans to LEAs to cover cash flow deficits caused by the delay of the June principal apportionment payment. The CSFA, or the California Department of Education (CDE), will keep you apprised of developments in this area.

### **Use of General Fund Reserves**

As discussed below, SBX1 18 provides budget flexibility to LEAs and authorizes them, for 2002-03 only, to free up some of their restricted and unrestricted General Fund reserves for payment of current year costs. The budget flexibility provided in SBX1 18 is allowed only to the extent that each district suffered from midyear budget reductions for the 2002-03 fiscal year that are enacted after January 1, 2003. Note that this flexibility applies only to the funds and accounts within the General Fund; it does not apply to any other fund type, i.e., special revenue funds (adult education, child nutrition, child development, etc.), capital projects funds, debt service funds, etc.

Midyear reductions to date include those to the following programs: Instructional Materials One-time Grants, Immediate Intervention/Underperforming Schools Program, High Priority Schools Grant Program, Peer Assistance and Review, School and Classroom Library Materials, Golden State Exam, Workforce Investment Act, California School Information Services, California Technology Assistance Project, Training and Staff Development for Classified Employees, and Assessments in Career Education. To help you determine the amount of midyear reductions, we are working on a listing of those amounts. That listing will be posted on our Web site, along with this memorandum, at: <<http://www.cde.ca.gov/fiscal/financial>>.

Because there is no certain time when the K-12 Mandate Claims will be appropriated, we believe it is also appropriate to treat mandates as a midyear reduction for this purpose; the amount of the midyear reduction would essentially be the total amount of mandate funds you were expecting to receive in the 2002-03 fiscal year, regardless of whether that amount was for settle-up of prior year actual costs or current year estimates. Conversely, we do not believe this budget flexibility applies to deferred appropriations, which are discussed in further detail later in this memorandum.

The Legislature's intent, while not binding, is that the reserve flexibility made available by SBX1 18 should be used for the following priorities to the extent that these programs suffered budget reductions: Peer Assistance and Review program, Supplemental Instruction and Remedial programs, and one-time funding for the Instructional Materials Funding Realignment program.

### Restricted Reserve Balances

*Education Code* Section 33128.2, as added by SBX1 18, provides that an LEA may use for purposes determined by its governing board “up to 50 percent of the balances, as of July 1, 2002, of restricted accounts in its General Fund ... in order to provide local budgeting flexibility as a result of midyear budget reductions for the 2002-03 fiscal year that are enacted by the Legislature after January 2003.”

For purposes of calculating the 50 percent amount, start with the July 1, 2002 beginning balance (i.e., the June 30, 2002 ending balance) in your General Fund restricted accounts, and subtract any restricted balances committed for capital outlay, bond funds, sinking funds, and federal funds. Then, multiply the total by 50 percent. Compare that number to the total amount of midyear cuts (discussed on the previous page) incurred by your agency. The amount you can redirect pursuant to SBX1 18 is the lesser of those two amounts.

We believe the intent of SBX1 18 is that “50 percent of the balances, as of July 1, 2002, of restricted accounts in its General Fund,” includes state restricted carryover amounts booked in the deferred revenue account. However, caution must be used to avoid violating any contractual obligations of a specific contract for services or grant, and it is advisable to communicate the intention to redirect deferred revenues with the grantor if there is any doubt about the appropriateness of this transaction.

Once you have calculated the amount of restricted balances that may be redirected, the actual funds being redirected can come from any number of the programs with July 1 balances, i.e., the entire amount can come from a single program’s balance, or can be taken proportionally from all eligible programs. For example, if an LEA has one particular program with a July 1 balance equal to at least 50 percent of all restricted balances, the LEA can redirect all of its 50 percent amount from that program’s ending balance pursuant to SBX1 18. Note that SBX1 18 does not require that the redirected funds be repaid to the restricted program.

We recommend that LEAs account for this budgeting flexibility by recording a contribution from the resource of the restricted program from which the balance is being used, to the resource of the program benefiting from its use (typically, an unrestricted resource), using Object Code 8990. Recording a contribution from a restricted resource to an unrestricted resource is an unusual accounting treatment, but it is an accurate accounting treatment under unusual circumstances. This accounting treatment will clearly identify the amount of each program’s funds that were used pursuant to SBX1 18, and will avoid charging potentially noncompliant expenditures to restricted program resources.

### Reserve for Economic Uncertainties

SBX1 18 provides that, notwithstanding the Criteria and Standards, an LEA may use up to 50 percent of its reserve for economic uncertainties, for 2002-03 only, to provide local budgeting flexibility as a result of midyear 2002-2003 budget reductions.

A reviewing agency, when assessing an LEA's fiscal solvency pursuant to the Criteria and Standards, must therefore take into consideration that the absence of the normally recommended 2002-03 reserves for economic uncertainties, alone, should not automatically result in a qualified certification. However, SBX1 18 does not exempt the reviewing agency from oversight responsibility for monitoring the LEA's fiscal well-being, nor does SBX1 18 protect the LEA from financial jeopardy, which is what reserves are intended to accomplish.

We recommend that reviewing agencies approving positive certifications that they believe would have been qualified if not for SBX1 18, should include language in their review letters to the effect that the reason the certification is not changed from positive to qualified is because of SBX1 18, and cite the reviewing agency's specific concerns.

The bottom line for reviewing agencies is whether or not the district or county in question is a viable, going concern, and whether any spending of reserves or recognition of deferred appropriations jeopardizes or obscures the agency's financial position. This is often not an easy assessment even in good fiscal times, but given the myriad of issues and exceptions granted for the current and budget year, it will be especially challenging. As always, good communication and full disclosure of the rationale for approving or not approving an interim certification or budget will be key.

### **Budgeting and Financial Reporting**

*Education Code* Section 33128.1, as added by SBX1 18, states that LEAs "may recognize for budgetary and financial reporting purposes any amount of state appropriations deferred from the current fiscal year and appropriated from the subsequent fiscal year for payment of current year costs as a receivable in the current year." This means that statute specifically allows LEAs to recognize in 2002-03 those revenues that would normally have been appropriated in the 2002-03 fiscal year, but whose appropriation was deferred until 2003-04. This language applies to the June 2003 payment of the second principal apportionment, and 2002-03 deferred appropriations for the Home-to-School Transportation, School Improvement, Targeted Instructional Improvement, and Supplemental Grant programs appropriated in 2003-04 pursuant to Chapter 1167, Statutes of 2002.

Note, however, that while state law allows recognition of these deferred appropriations, the Governmental Accounting Standards Board (GASB) has made clear that in accordance with GASB Statement 33, in the absence of an appropriation, and if the grantor agency does not recognize a liability at year-end, the recipient agency should not recognize a receivable. To

illustrate this point, in his signing message of SBX1 18, the Governor states that, “Deferring the June principal apportionment is inconsistent with generally accepted accounting principles.” We understand that the State may recognize a liability for these deferred appropriations in its 2002-03 financial statements; however, we do not yet know for certain whether this will occur.

Therefore, if you do plan to recognize a receivable for these deferred appropriations at year-end, we urge you to discuss it with your auditor. Depending on the materiality of the accrual in relation to your financial statements, if this accrual is determined by your auditor to be a departure from generally accepted accounting principles (GAAP), it could result in an audit adjustment or could impact the opinion your auditor renders on your financial statements.

Note also that SBX1 18 states that the receivables for those deferred appropriations may be recognized *for the payment of current year costs*. This language implies that if an LEA makes budget cuts in the current year in response to the deferral of certain program revenues, there would be no need to record a receivable of current year revenues for payment of current year costs.

### **Impact of Appropriation Deferrals on Transportation Funding**

An LEA’s transportation entitlement in a given year is normally the lesser of its transportation entitlement in the prior year or its transportation expenditures in the prior year. Deferring 26.86 percent of the 2002-03 transportation appropriation until 2003-04 could have had two unintended consequences. First, reducing the amount of an LEA’s entitlement in 2002-03 could have caused a permanent reduction to the LEA’s transportation entitlement in future years. To avoid this unintended consequence, and consistent with Assembly Bill 2781 trailer bill language for the 2003-04 transportation entitlement deferred from 2002-03, CDE will, for the purpose of calculating LEA transportation entitlements, consider the funds deferred to 2003-04 as part of the entitlement for the year in which the funds were intended, i.e., 2002-03. In this way, the historical entitlement will be maintained in 2002-03 and, consequently, in 2003-04.

The other unintended consequence could have occurred on the expenditure side. If an LEA chooses to spend only what it receives in transportation funding in 2002-03, and if its total expenditures are therefore less than its entitlement, that LEA would experience a permanent reduction to its transportation entitlement in 2003-04. To avoid this unintended consequence, and again consistent with AB 2781 trailer bill language for the 2002-03 transportation entitlement deferred to 2003-04, CDE will, for the purpose of calculating LEA transportation entitlements, consider the 2003-04 expenditures associated with the deferred transportation appropriation as being expended in the year for which the funds were intended, i.e., 2002-03. In this way, LEAs will be able to maintain historical funding levels in both 2002-03 and 2003-04.

In doing this, CDE will consider as 2002-03 expenditures only the amount necessary to allow the district to match its 2002-03 entitlement. Also note that expenditures in 2003-04, less those attributed to 2002-03, will influence the level of funding in 2004-05.

### **Calculation of 2002-03 Entitlements**

Pursuant to the AB 2781 provisions, the 2002-03 appropriations deferred until 2003-04 are subject to the 2002-03 funding requirements, meaning, among other things, the criteria that are used to calculate the 2002-03 entitlements will also be used for the portion of 2002-03 appropriations that were deferred until 2003-04. Although there are clearly two separate appropriations for these items (one for 2002-03 and one for 2003-04), the entitlement calculations for each year will be the same, i.e., the two appropriations will be combined for calculation purposes.

### **Impact of Deferred Appropriations on Categorical Flexibility Transfers**

As in recent years, Section 12.40 of the 2002-03 *Budget Act* allows LEAs to transfer a limited amount of funds between certain categorical programs. The limitations placed on each LEA's ability to shift funds between programs are based on a percentage of each LEA's apportionment.

Home-to-School Transportation, School Improvement Program, and Targeted Instructional Improvement Grants are included in the list of programs eligible for flexibility transfers. Normally, only the amounts appropriated in 2002-03 would be considered for the purpose of determining the maximum level of funds that could be shifted in 2002-03. However, if you recognize a receivable for deferred appropriations in accordance with the provisions of SBX1 18, you may also count the corresponding revenue in determining your maximum categorical flexibility transfer.

### **Effect on Federal Maintenance of Effort Requirements**

If you receive federal No Child Left Behind (NCLB) funds, you have a maintenance of effort (MOE) requirement that you must fulfill or risk losing a portion of the federal funds. Simply put, current year expenditures from state and local funds must be at least 90 percent of your prior year expenditures from state and local funds.

If you fail to meet this MOE requirement as a result of the deferral of appropriations from 2001-02 to 2002-03 or from 2002-03 to 2003-04, you can request a waiver of the MOE requirements from the Secretary of the U.S. Department of Education. (Note: Your level of expenditures for 2001-02 and 2002-03 will influence the MOE test for NCLB funding in 2003-04 and 2004-05, respectively.) While there is no guarantee that a waiver will be granted,

the Secretary, according to Section 9521 of the NCLB Act, may waive the MOE requirements “if the Secretary determines that a waiver would be equitable due to (1) exceptional or uncontrollable circumstances, such as a natural disaster; or (2) a precipitous decline in the financial resources of the local educational agency.”

These are difficult and challenging times for all LEAs. We hope this letter clarifies some of the cash borrowing alternatives available to you, and helps to clarify the budget flexibility provided by SBX1 18. Questions related to transportation funding, entitlement calculations, and categorical flexibility transfers may be directed to the Office of Management Assistance and Categorical Programs at (916) 327-0538. All other questions may be directed to our Office of Financial Accountability and Information Services at (916) 322-1770 or [sacsinfo@cde.ca.gov](mailto:sacsinfo@cde.ca.gov).

*NOTICE:* The guidance in this memorandum is not binding on local educational agencies or other entities. Except for the statutes, regulations, and court decisions that are referenced herein, this memorandum is exemplary, and compliance with it is not mandatory. (See *Education Code* Section 33308.5.)